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TAGS: EINV EFIN ECON IN
SUBJECT: INDIAN CORPORATE BOND MARKET MOVING SLOWLY BUT STEADILY FORWARD

MUMBAI 00000238 001.2 OF 004

¶1. (SBU) Summary: Since September 2008, the Indian corporate bond market has witnessed an increase in trading volumes as Indian companies found it difficult to raise money through other routes. Both the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) have taken incremental steps to increase market volumes. However, while primary issuances have grown, trading of issued bonds in the secondary market continues to lag behind. One reason for this is that many banks and asset management companies tend to hold corporate bonds until maturity, creating a lack of liquidity in the secondary market. In addition, the requirement for banks to hold government securities diverts funds away from the corporate bond market. Overall, many small distortions and disincentives remain in the system that discourage the development of a corporate bond market. Since there is no one switch that can be turned on to create a robust corporate bond market, regulatory tinkering will likely continue for the near future. End Summary.

Regulators Hand in Hand to Develop Bond Markets

¶2. (U) In 2009, the Ministry of Finance along with SEBI, the capital market regulator, and the RBI, India's central bank and banking regulator, have continued to take steps to stimulate the corporate bond market. In January 2009, the Ministry of Finance increased the cumulative debt investment limit from $6 billion to $15 billion for foreign institutional investor (FII) investments in corporate debt. On May 11, SEBI simplified the listing procedures for debt securities in order to develop the primary market for corporate bonds in India. Most trading in this market is over-the-counter (OTC), as there is no formal exchange traded platform yet. In the annual policy statement released in April 2009, the RBI announced a new trade-by-trade settlement process consistent with OTC activity. Interlocutors mentioned that much of the work for exchange-based trading has been done, including the establishment of corporate bond trading platforms at the National Stock Exchange and Bombay Stock Exchange. However, the RBI's announcement is an admission that OTC activity will continue to dominate for the time being.

¶3. (SBU) Dhiren Mehta, Director of Emerging Markets at Citibank, and Ashish Ghiya, the Managing Director of Derivuim Capital believe the new FII limit of $15 billion is sufficient to generate interest from the trading desks of foreign banks. However Mehta estimated that FIIs would take almost a year to hit this limit; since most FIIs buy bonds to hold until maturity, the increase in volume would not spur increased use of the secondary market. Jeevan Sonparote, who monitors FII registration and participation at SEBI, expressed disappointment with the pace the new limit was being utilized, especially since SEBI has made it easy for corporations to issue corporate debt, he said. For a company already listed on stock exchanges seeking to offer debt securities, SEBI has reduced the amount of information the company needs to disclose, and new guidelines emphasized electronic disclosure to save on cost and time of issue. However, Mehta described the new, shortened period -- three weeks -- as still too long, given that market conditions can change drastically in three weeks.

¶4. (SBU) Looking ahead, many minor reforms await RBI action. Both Mehta and Sonparote described the ability to lend, or "repo," bond holdings to enhance returns awaits the RBI's finalization of the clearance mechanism. Exchange-traded interest rate derivatives should be announced in the next six months, which will help bond holders separate out various forms of risk. The RBI has also begun the process of introducing "strips," where government bonds can have the principal and interest payments traded separately. SEBI expects FIIs to be allowed to participate in primary issuance within one-to-two months, so they won't have to rely on miniscule secondary market activity to acquire positions. Finally, Ministry of Finance Director Gopal Nair expected the negotiations on harmonizing state-imposed stamp duties to continue with the new government, but progress is slow.

Corporate Bond Market Volumes Picking up in the Primary Market

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¶5. (SBU) According to data from SEBI, listed companies have raised about $42.27 billion of bond capital through private placements of corporate bonds during April 08- March 09, a 1.6 times year-on-year increase. Media reports suggest that as more companies find it difficult to access funds from issuing equity and external avenues such as external commercial borrowings, the corporate bond route has become more attractive. Mehta noted extreme domestic liquidity, rather than a return to normally functioning markets post-crisis, driving the demand side. Sonparote remarked that although both the number of bond issuances and the capital they raised have picked up, the growth in the latter has not been significant. The growth in number of issues is likely due to individual companies accessing the market multiple times for smaller offerings. He thought that these companies may not be able to raise a large amount in a single debt offering. Ghiya indicated that despite continuous reforms in the corporate bond market, volumes were not picking up, as the regulator lacked an understanding of the market's participants. He elaborated that when stock markets were developed, SEBI focused on three classes of investors -- FIIs, domestic institutions and retail investors. However, in the corporate bond market, retail investors are insignificant, so SEBI needs to focus on FIIs and domestic institutions and increase their participation. To his disappointment, SEBI is trying to replicate the same approach it took with the development of equity markets in the corporate bond market.

Increase in Primary Bond Issuances Not Translating into Volumes in the Secondary Market

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¶6. (U) While primary issuances have been growing, most of these are by public sector financial institutions and issued on a private placement basis to institutional investors. Ghiya estimated that despite an annual issuance of about $9.5 billion worth of corporate bonds by public sector undertakings (PSUs), the most liquid segment, the daily trading turnover of the secondary market was only about $21 million. The implication is that it could take an uncomfortably long time to sell a large bond holding if one wanted to exit the market. Mehta from Citibank explained that bond markets are driven by liquidity, regulation, and the investment needs of the different classes of investors. He elaborated that each investor's risk appetite varies due to their unique risk profile. Asset management companies (AMCs), 70 percent of whose assets are institutional money, tend to invest in the shorter end of the bond market, normally maturing in one to three years. For instance, Reliance Mutual Fund has assets of about $20 billion under management; 75 percent of these assets must be in highly liquid investments because they could be withdrawn on a one-to-two day notice. He added that generally AMCs buy bonds to park excess cash and are not necessarily making a strategic investment decision when they buy corporate debt.

¶7. (U) In contrast, insurance companies tend to hold bonds of maturities 10 years or longer, since they must manage longer term assets and liabilities. The government-owned Life Insurance Corporation, one of India's largest insurance companies, has adopted a conservative style of investing and holds 10-30 year bonds. Government- and privately-managed provident and pension funds are also extremely conservative, due to their purpose as retirement funds. Ghiya noted that recently, retirement and pension funds had relaxed some of their investment guidelines, but he believed that they would hold longer term debt till maturity. With so many buy-and-hold participants, liquidity comes almost exclusively from foreign banks and primary dealers. However, Mehta noted that when

interest rates are not favorable, these parties lose interest and liquidity vanishes completely.

Indian Banks Find Direct Lending More Attractive than Buying Corporate Debt

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¶8. (U) At present, Indian banks have different accounting norms for holding loans and bonds; these norms -- and the fact that banks earn higher interest rates from direct loans -- make corporate bonds less attractive. Banks charge about nine percent or more interest for loans, but they do not have to use mark-to-market (MTM) accounting for such loans. In contrast, banks earn only about eight percent interest for holding corporate bonds and must record them on a MTM basis, which is more cumbersome than accounting for direct loans. While there is no risk differentiation between corporate loans and bonds, Ghiya pointed out that the incentive for corporate lending in lieu of holding corporate bonds will be lost once banks implement Basel II norms. As a result, all corporate lending would be treated on the same risk basis for capital adequacy purposes, which may make corporate bonds more attractive than they are currently for Indian banks.

Government Bond Market

¶9. (U) Traditionally, banks and insurance companies have been the largest holders of government securities (GSecs). The major part of the holdings of these investors is generally in the nature of statutorily-mandated investments; Indian banks are required to maintain 24 percent of their deposits in government securities. N.S. Venkatesh, Managing Director and CEO, IDBI Gilts, described banks as the major captive buyers of government bonds. In addition, insurance companies, provident and pension funds are required to invest 20-25 percent of their assets in GSecs. In total, the banking and insurance system holds almost 60 percent of issuances, making them unavailable for trading in the secondary market, he claimed. Non-Banking Financial Companies (NBFCs), another major player in the bond market, are also required to invest 15 percent of their assets in GSecs.

¶10. (U) Venkatesh estimated that in 2008, about Rs. 3.06 trillion worth of government bonds, or about $65 billion, were issued in the primary market but the trading volume in the secondary market was about Rs. 12 trillion or $255 billion. This indicates that the trading volume is 5 times the volume of issuances in the primary market. However, the same trading volume in developed countries ranges from 10 to 12 times of annual issuances. The Indian GSec market has no retail participation, he complained, which he blamed on low investor awareness and low returns, compared to other avenues of investment. Competing with G-sec, a five-year fixed deposit through the government-sponsored small saving scheme currently pays eight percent interest, tax free. In contrast, government bonds pay roughly 4.5 percent taxable interest, making GSecs unattractive to retail investors. FIIs are unlikely to provide the secondary market trading volumes in G-secs either, because their holding cap in this market is only $5 billion. Many market observers noted that at such small amounts FIIs will not invest the resources to be active traders. Ghiya further noted that the new scheme for allocating FII holdings, just implemented May 15, poorly suits the rush-in, rush-out arbitrage positions FIIs prefer to take.

¶11. (SBU) Comment: While the Indian government, SEBI and RBI continue to take small steps to build a robust and liquid corporate bond market, the domestic government bond market still dwarfs it. Market players dismiss regulators' apparent focus on

cultivating retail participation, and many expect FIIs to eventually jump-start trading. All agree that there is no single switch that can turn on a robust corporate bond market, in part because so many distortions and disincentives remain to be disentangled. Hence, regulators and practitioners continue to tinker and advance, hoping they eventually hit some sort of tipping point at which market development takes on a momentum of its own. End Comment.
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